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## CABINET AFFAIRS STAFFING MEMORANDUM

Date: 5/14/84 Number: 168988CA Due By: \_\_\_\_\_

Subject: Cabinet Council on Economic Affairs - May 15, 1984 - 8:45 a.m.

Roosevelt Room

TOPIC: Risk Related Insurance Legislation

ALL CABINET MEMBERS	Action	FYI	Action	FYI
Vice President	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Defense	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Attorney General	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Interior	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Agriculture	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Commerce	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Labor	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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HUD	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Transportation	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Energy	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Education	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Counselor	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
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Deaver	<input type="checkbox"/>	<input type="checkbox"/>
Darman (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Jenkins	<input type="checkbox"/>	<input type="checkbox"/>
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CCCT/Gunn	<input type="checkbox"/>	<input type="checkbox"/>
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CCFA/	<input type="checkbox"/>	<input type="checkbox"/>
CCHR/Simmons	<input type="checkbox"/>	<input type="checkbox"/>
CCLP/Uhlmann	<input type="checkbox"/>	<input type="checkbox"/>
CCMA/Bledsoe	<input type="checkbox"/>	<input type="checkbox"/>
CCNRE/	<input type="checkbox"/>	<input type="checkbox"/>

## REMARKS:

The Cabinet Council on Economic Affairs will meet on Tuesday, May 15, 1984 at 8:45 a.m. in the Roosevelt Room.

The agenda and background paper are attached.

## RETURN TO:

<input type="checkbox"/>	Craig L. Fuller Assistant to the President for Cabinet Affairs 456-2823	<input type="checkbox"/>	Katherine Anderson Tom Gibson Associate Director Office of Cabinet Affairs 456-2800	<input type="checkbox"/>	Don Clarey Larry Herboldsheimer
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THE WHITE HOUSE  
WASHINGTON

May 14, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*  
SUBJECT: Agenda and Papers for the May 15 Meeting

The agenda and paper for the May 15 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will discuss a report from the Working Group on Financial Institution Reform regarding federal deposit insurance legislation. A memorandum from the Working Group on two pieces of legislation proposed by the Federal Deposit Insurance Corporation (FDIC) revising the Federal Deposit Insurance Act and giving the FDIC and the FHLBB the authority to set a cap on insured brokered deposits held by insured banks and thrifts is attached.

Attachments

THE WHITE HOUSE  
WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

May 15, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Risk related insurance legislation (CM # 472)



ASSISTANT SECRETARY

## DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

May 14, 1984

## MEMORANDUM FOR CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Thomas J. Healey *1*

SUBJECT: CCEA Working Group Decision Memorandum on the Federal Deposit Insurance Corporation's Two Proposed Bills

The CCEA is asked to develop the Administration's position on two bills proposed by the FDIC, i.e., (1) the revised "Federal Deposit Insurance Improvements Act" and (2) a draft bill giving the FDIC and the FHLBB the authority to set a cap on insured brokered deposits held by insured banks and thrifts.\*

The CCEA Working Group is currently preparing a major report on the scope and purpose of the Federal deposit insurance system, in light of the recent structural changes in the depository institutions industry. Because that report has not been completed and the CCEA has not adopted an overall position on the status of the deposit insurance system, the Working Group is not sure the FDIC's bills are the best way to address problems within the insurance system; but since the proposed legislation may soon be introduced in Congress and might be part of the omnibus financial institutions bill that is expected to become law this year, CCEA policy direction is needed regarding several important provisions of the bills.

In November of 1983, Senator Garn, at the request of the FDIC, introduced the Federal Deposit Insurance Improvements Act of 1983 (FDIIA), S. 2103. The Working Group found the following provisions in the Improvements Act require attention from the CCEA:

- permitting the FDIC to adjust the assessment credit for any given bank according to the risk that the bank presents to the insurance fund;
- preempting state laws by establishing the FDIC as the receiver of all insured banks and by establishing priorities for distributing the assets of failed insured banks;

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\* In lieu of taking a position on the FDIC proposals, the FHLBB is expected to forward its own legislative proposals to Congress shortly. The Working Group plans to analyze the FHLBB bill and ask the CCEA for policy direction, if necessary.

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- increasing the enforcement powers of the FDIC, such as cease and desist orders, over all insured banks, including national banks and state member banks; and
- authorizing the FDIC to charge examination fees.

Recently the FDIC has indicated that it will ask Senator Garn to introduce a revised version of the bill. This revised bill is very similar to the 1983 bill, but has two additional controversial sections:

- gives the FDIC's Board of Directors the power to categorize deposits and to declare that the deposits in any such category are ineligible for FDIC insurance; and
- strengthens the FDIC enforcement powers by, among other things, giving the banking agencies, including the FDIC, more authority to control the relationships between a bank and its officers, directors, employees, agents, and other people participating in the bank's affairs.

#### I. Sections of the Improvements Act that Need CCEA Policy Direction

The three major problem provisions in the Improvements Act that need CCEA policy direction as well as a draft bill to set a cap on insured brokered deposits are discussed below. The other two controversial sections of the Improvements Act, both of which the FDIC has agreed to alter to satisfy the Working Group's concerns, are summarized in the Appendix to this memorandum.

##### (1) Risk Related Rebates

Section 6 of the Improvements Act of 1984 would give the FDIC a great deal of flexibility in setting the assessment credits to be returned to insured banks. The FDIC would continue to rebate approximately 60 percent of its aggregate net assessment income\* to the banks; but the FDIC would set the assessment credit for each insured bank on the basis of the risk that the bank may present to the insurance fund.

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\* The rebates seldom amount to more than 4 percent of a bank's operating income before taxes.

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The bill gives the FDIC maximum flexibility by not specifying how risk would be measured or how much the rebates would be increased or lowered depending on the determined degree of risk each bank represents. However, the FDIC's April 15, 1983 study on "Deposit Insurance in a Changing Environment" suggests how the process might work. According to the study, there might be three risk classes -- normal, high and very high. The vast majority of all banks would fall into the normal risk class. The FDIC, when determining the class of a specific bank, would focus on capital, credit risk and interest rate risk. Capital is very important because it provides a protective cushion that reduces the potential exposure to the insurance funds. The FDIC's stated position is that a well run and well diversified bank should maintain capital accounts equal to at least five percent of total assets. The credit risk would be measured by the dollar volume of classified assets; and interest rate risk would be measured by computing the present value of potential changes in future pre-tax earnings resulting from a dramatic change in interest rates.

#### Arguments in Favor of Risk Related Rebates

Since the 1930s, the level and variation of risk taking within the banking industry has been very low because banks have been closely controlled through regulation and supervision. Bank markets and products have been limited and the economy has been relatively stable and growing. Both of these factors are changing.

Since the early 1980s, the incidence of bank failures has been on an upward trend. During the 20 years preceding 1975, the number of bank failures averaged only 4.2 per year but increased to 10 per year for the period 1975 through 1981. In 1982 there were 42 failures, in 1983 there were 48 and the number of failures in 1984 is expected to be in the 40s.

The present structure of the domestic insurance system provides banks with an artificial incentive to take on additional risks. Deregulation has made it easier for them to do so. The prospect of rising risk levels and increased failures suggests that a risk based insurance system may be appropriate.

The American Bankers Association supports this concept because risk related rebates would reduce the inequity of the current system whereby high risk banks pay the same rate for insurance as low risk banks. Because insurance losses currently are passed on to insured, safely-run banks in the form of reduced rebates, the safely-run banks must absorb the costs when the higher risk banks fail.

In addition, risk based rebates should encourage bank managers to consider the impact of their decisions from the insurer's standpoint.

The FDIC would try to develop an objective standard for determining the classification of a bank and in this way reduce the number of appeals from banks that think they have been incorrectly classified.

#### Problems with Risk Related Rebates

It has been argued that the size of the differential in rebates would be too small to change a bank management's behavior. The current premiums are all assessed at the base rate of 1/12th of one percent of domestic deposits. Even before insurance losses reduced the credits over the last few years, rebates were usually less than 4 percent of operating income before taxes. Thus, even if a bank classified as a very high risk received no rebate, the total cost of the penalty would be quite small. However, as the regulators gain experience with such a system, wider premium differentials may become justified.

Although the proposed legislation does not specify the criteria that the FDIC would use to identify normal, high risk and very high risk banks, the FDIC has suggested that the method would differ from the Uniform Interagency Bank Rating System known as CAMEL (capital, assets, management, earnings and liquidity). The CAMEL ratings include subjective decisions about a bank but all the risk rating measurements are expected to be based on objective factors. Therefore, it would be possible for a bank considered a problem bank according to CAMEL to be classified as normal or low risk, if for example, it had a high capital/asset ratio. Having two classification systems might confuse investors and give them a false sense of security, (especially if the FDIC disclosed the risk ratings of banks, but continued to keep CAMEL ratings secret).

The Working Group has no problem with the disclosure of ratings, per se, as this Administration has consistently followed the principle that information the experts can determine easily should be made available to small investors so the less sophisticated will not be at a disadvantage. The only problem with disclosure of the risk rating would arise if it made investors feel they were investing in a safely run bank with a normal risk rating, when in fact the bank according to the CAMEL ratings was considered a problem bank.

Vice President's Task Group

The Vice President's Task Group Recommendations state "The FDIC and FSLIC should be authorized, but not required, to institute systems of risk based insurance premiums, provided that any such system should include utilization of independent private sector indices of risk to the extent feasible."

Agencies' Views

The OCC supports changing the way deposit insurance is priced and believes the proposed risk based rebate plan is a positive first step towards explicit risk based insurance premiums. It would not oppose adding language to the FDIC bill that explains in general terms the factors the FDIC will consider in judging a bank's riskiness.

The FHLBB is developing its own legislation to address the FSLIC's problems and does not want the risk related rebate provision included in its statute. More to the point, the FSLIC will not be able to rebate premiums in the near future because of the demand on the FSLIC fund.

The FRB believes that even if risk based insurance premiums were more effective in instilling the market discipline needed in a more deregulated environment, this alone would not be sufficient to assure a safe and sound banking system. The deregulation process implies a high degree of uncertainty on the part of bankers, depositors, creditors, and regulators as to the stability characteristics that may develop in the banking system and financial markets.

Recommendation

Although premium differentials would be small, they might make some bank managers and investors more cautious and would subject banks to more market discipline. The Vice President's Task Group on Regulation of Financial Services approved the policy of risk related premiums. However, the Working Group believes that the bill should be more specific and at least include objective criteria for establishing a bank's classification as normal, high risk or very high risk. Furthermore, the FDIC bill is silent on the issue of disclosure of banks' ratings. The Working Group believes that if risk related rebates

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are implemented, risk classifications should be disclosed along with the objective criteria for these ratings. The bill, as written, gives the FDIC too much leeway in defining risk characteristics.

Agree \_\_\_\_\_

Disagree \_\_\_\_\_

Other \_\_\_\_\_

#### (2) Enforcement Powers

Section 7 of the Improvements Act of 1984 eliminates the present requirement that the chartering authority and the insured bank be given up to 120 days to correct violations of laws or to end unsafe or unsound practices. The FDIC staff estimates that this change will reduce the period required for reaching the final determination of any removal of insurance by six months.

This section of the Improvement Acts also provides that the term "appropriate Federal banking agency" not only has its usual meaning, but also includes the FDIC in the case of insured banks. The change gives the FDIC enforcement powers (*i.e.*, cease-and-desist powers) over national and state-member banks. The Office of the Comptroller of the Currency (OCC) is currently the only Federal regulator that has cease-and-desist powers over national banks, the Federal Reserve Board (FRB) has this power over state member banks and the FDIC has this power over state non-member banks.

#### Arguments in Favor of the FDIC's Stronger Enforcement Powers

The FDIC states that the enforcement power it has now over national and state member banks (withdrawing a bank's insurance coverage) is such a drastic measure that it is seldom used. Therefore, they want authority to issue temporary orders that remove or place limitations on the activities or functions of a bank, its directors, officers, employees, or agents, in addition to other powers. This change would permit a less onerous means of addressing problem situations than total removal of insurance.

The Vice President's Task Group Recommendations state that the FDIC should retain its current authority to revoke insurance for both state and Federally chartered institutions engaging in unsafe or unsound practices. In addition, the FDIC

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should have the authority to request the relevant supervisor to take any other enforcement action applicable to any insured bank or its officers and directors. Where the supervisor declined to take such action, the FDIC should be entitled to initiate such action independently if the FDIC Board of Directors, based on an examination of any such banks by the FDIC, determines such action to be necessary under statutory standards relating to unsafe and unsound banking practices by an insured bank or its management.

Arguments Opposed to the Increased FDIC Enforcement Powers

The Improvements Act authorizes the FDIC to have enforcement powers over all insured institutions but does not include the Vice President's Task Group's provision that the FDIC must first ask the primary regulator or supervisor to take enforcement action and only after the request is denied, can the FDIC take action. The Improvements Act, therefore, would create duplication and overlapping regulation of banks, which is in direct contrast to the stated goals of the Vice President's Task Group.

Agencies' Views

The OCC strongly opposes the current enforcement provisions of the FDIIA for two reasons. First, they are inconsistent with the Vice President's Task Group Recommendation that the FDIC would take enforcement actions only when, and if, the primary regulator refused to take the requested action. Second, even if the provisions were amended to conform with the Task Group's recommendation, the OCC firmly believes that any expansion of the FDIC's enforcement authority should be granted only as part of the adoption of the Task Group's more comprehensive set of recommendations.

The FRB has stated that "the Vice President's Task Group on Regulation of Financial Services only recently issued recommendations concerning possible steps to revise the regulatory and supervisory structure. The Board believes that this aspect of the proposed legislation is not consistent with the Task Group's report. Since the Task Group recommendations cover a broad and integrated set of issues, the Board believes that it is premature to expand current supervisory and regulatory powers of any one agency until the Congress has considered the proposals as an integrated package."

Recommendation

While the Working Group is in conceptual agreement with the proposal, it recommends that this provision be considered at the time that all legislation arising from the Vice President's Task Group Recommendations is addressed. The Working Group believes it is unwise to ask Congress to consider separately individual sections of the Vice President's Task Group Recommendations.

Agree \_\_\_\_\_

Disagree \_\_\_\_\_

Other \_\_\_\_\_

(3) Categories of Deposits Eligible for Insurance

Section 3 of the Improvements Act of 1984 would authorize the Board of Directors of the FDIC to establish by regulation categories of deposits and to determine whether the deposits in any such category are eligible or ineligible for Federal deposit insurance.

The FDIC has stated that some examples of categories of deposits that it might determine as ineligible for insurance include: (1) deposits placed by deposit brokers; (2) deposits representing funds owed by one depository institution to another; (3) deposits made in banks whose deposits are fully insured by a state agency or program; and (4) deposits made by a government agency. The legislation, however, does not specify what the categories would be.

Arguments in Favor of Giving the FDIC Broad Authority

The FDIC believes that broad authority is necessary in order to prevent abuses of the insurance system. The proposed categories of accounts ineligible for insurance would be published in the Federal Register and commented on by the public in keeping with normal regulatory procedure. The FDIC states that it needs flexibility so it can act more quickly than is possible through the legislative process, if the market develops new ways to take advantage of the insurance system.

Arguments Opposed to the Broad Authority

The breadth of the proposed discretionary authority requested by the FDIC is considerably greater than agencies are generally given. Congress, historically, has determined the

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maximum amount of any one depositor's funds in an institution that is insured and has not set limits other than size on insured deposits.

Although the American Bankers Association (ABA) supports the FDIIA in general, this leadership group believes that this provision gives the FDIC too much discretionary authority.

#### Agencies' Views

The OCC objects to giving the FDIC broad authority to categorize deposits for purposes of insurability. The OCC has prepared draft legislation on brokered deposits (that is discussed later in this memorandum) and prefers this approach to either the FDIC brokered deposits bill or the deposit categorization provisions in the FDIIA, both of which provide the insuring agencies broad discretion.

While the Federal Reserve Board shares the concerns of the FDIC on the need to prevent abuses of the insurance system, the breadth of the proposed discretionary authority requested by the FDIC is troublesome absent clearer indications of its use. It is, for example, not entirely clear, if the proper restraints are placed on brokered deposits, that there is evidence that any particular class of depositors will be able to abuse the insurance system. Moreover, it would seem desirable that the Congress determine the specific classes of depositors, if any, that should be entirely excluded from deposit insurance coverage. In any event, if such limitations and exclusions are either promulgated by a Federal agency or enacted by the Congress, it is important that depository institutions be required to inform depositors of their insurance coverage.

#### Recommendation

The Working Group recommends that the CCEA not support the FDIC's request for broad discretionary power to determine categories of accounts that are ineligible for deposit insurance, and that instead the FDIIA directly address insurance eligibility for specific categories of deposits.

Agree \_\_\_\_\_

Disagree \_\_\_\_\_

Other \_\_\_\_\_

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If the CCEA votes not to support giving the FDIC broad discretion to establish categories of accounts that are ineligible for insurance, then the CCEA should consider the three categories of accounts the FDIC believes should be ineligible for deposit insurance: (1) depository institutions, (2) government agencies, and (3) brokered deposits. (The brokered deposits issue is considered in both the FDIIA and in the proposed legislation that is discussed later in this memorandum.)

The FDIC has indicated that financial institutions and government agencies have placed over \$600 million in fully insured brokered deposits in 44 failed banks since the beginning of 1982. These deposits represented over 75 percent of all insured brokered deposits in failed banks during the period. The FDIC believes that the deposit insurance system was not intended to protect these types of deposits.

#### (1) Depository Institutions

The FDIC believes the single most important element of the proposed legislation is that depository institutions (such as credit unions, banks, and savings and loan associations) should not be eligible for insurance. The FDIC believes these institutions are managed by financially astute individuals who should be able to identify safely run depository institutions in which to invest. Furthermore, when a savings and loan association's deposits are invested in an insured bank, the deposits are insured twice; i.e., by the FSLIC and also by the FDIC. This type of double insurance is unnecessary.

Most small banks use the overnight Federal funds market to invest their excess short-term funds, while savings and loan associations and credit unions can now place their funds in industry sponsored and managed mutual funds or other financial intermediaries that offer professional money management.

The National Credit Union Administration (NCUA), however, points out that the Federal Credit Union Act limits credit union investments to Treasury or Federal agency securities and certificates of deposits in insured institutions. In addition, some small depository institutions are managed by part-time help. In many instances credit unions' boards and managers are workers or middle managers who are elected by their fellow workers and volunteer their time to the credit union. These people are not sophisticated enough or do not have the time to analyze the health of other depository institutions and, therefore, need the option of investing funds in insured accounts. In addition, the FDIC's proposal to prohibit credit unions and

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other depository institutions from obtaining Federal deposit insurance but not to treat more sophisticated financial institutions, such as investment banks and diversified financial services firms, in the same way does not seem fair. The NCUA would prefer an alternative approach that would not discriminate against credit unions and other thrifts.

The FHLBB will probably join the NCUA in opposing this provision. Savings and loan associations currently have about \$15 billion of insured credit union deposits.

It can also be argued that this provision deals with a symptom, not the basic problem. The real problem is troubled insured institutions and if the primary regulators and FDIC focused on this issue, they would not have to exclude certain groups from Federal deposit insurance.

#### Recommendation

Since this issue will be considered in the Working Group's report on the insurance system, it is recommended that the CCEA defer from taking a position on this issue until more analysis has been done.

Agree \_\_\_\_\_

Disagree \_\_\_\_\_

Other \_\_\_\_\_

#### (2) Government Agencies

There are really two major issues regarding insurance for funds of government agencies. The first issue is whether government agency deposits should be eligible or ineligible for deposit insurance. The second issue concerns the appropriate investment policies for agencies of the U.S. government.

Regarding the first issue, the FDIC is critical of Federal agencies that place insured deposits in failing institutions to gain higher than general market interest rates. The Bureau of Indian Affairs (BIA), the only significant example, manages a portfolio for various tribes by placing over \$1 billion of their funds in insured CDs. Since January 1983, the FDIC has found substantial BIA deposits (about \$50 million) in 17 failed banks. The Secretary of the Interior does have statutory authority to

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permit the BIA to invest in securities other than Treasury securities, including insured deposits. The FDIC and the BIA are currently working to develop an investment program to assure that the funds are invested in deposits in other than high risk institutions.

With regard to the broader question of the appropriate investment policy of government agencies, it has long been the Administration's policy that a Federal government agency must invest its own funds in U.S. Treasury securities. However, when a Federal government agency acts as a trustee, but has full liability for the invested funds, the Administration's policy is not clear. Also, in the case when the agency has no liability, there seems to be no policy.

The government clearly, according to the Treasury Department, should not be raising additional funds, by increased Treasury borrowing in the market, while it is investing funds in deposits or other market instruments. Furthermore, there is a serious question in the case (such as the BIA) where the agency bears liability whether any risk, however nominal, is appropriate. OMB has reviewed this issue in the past and believes the BIA has a special fiduciary responsibility to Indian tribes and should be allowed to invest these Indian funds outside of Federal securities.

Federal agencies oppose legislated investment restrictions and will most likely oppose legislation that denies them insurance for their deposits because these limits would reduce the return on their trust or other funds. The BIA has been holding discussions with Treasury regarding its investment policies.

#### Recommendation

The first issue regarding the eligibility of government agency deposits for insurance will be considered in the Working Group's report on the Federal deposit insurance system. Therefore, it is recommended that the CCEA defer from taking a position on this issue until the Working Group has finished its report. The broader issue of an appropriate investment policy for government agencies should be the subject of a separate CCEA Working Group study.

Agree \_\_\_\_\_

Disagree \_\_\_\_\_

Other \_\_\_\_\_

(3) Brokered Deposits

This provision in the FDIIA would give the FDIC the ability to establish brokered deposits as one of the categories that is ineligible for Federal deposit insurance. This is one of several approaches to the brokered deposits problem. Regulations recently adopted by the FDIC and FHLBB limit the insurance of each deposit broker to \$100,000 per institution, this effectively prohibits the "pass through" of deposit insurance to the original depositor. A third method is outlined in the draft legislation described below that would give the FDIC and FHLBB authority to set a "cap" on the amount of brokered deposits any one institution could accept.

The FDIC would like to have all three methods but prefers the current regulations and the authority to establish categories of accounts, including brokered deposits, that are ineligible for deposit insurance. The FDIC believes flexible authority is of primary importance.

The CCEA Working Group believes that the authority of the insurance agencies to deal with brokered deposits should be strengthened but prefers legislation as discussed below.

II. Draft Bill Giving the FDIC and FHLBB Authority to Set a "Cap" on the Brokered Deposits

The FDIC Board members were asked by members of Congress to consider whether they could support any legislation altering the recent regulation by the FDIC and the Federal Home Loan Bank Board limiting insurance coverage for brokered deposits. Although the FDIC is firmly convinced that their brokered deposits regulation is the most appropriate response to the brokered deposits problem, they have drafted a bill which they could support if Congress found it desirable to include it in an overall deregulation package, provided that the key elements of the insurance reform proposals in the Federal Deposit Insurance Improvements Act are adopted.

The bill would authorize the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board to establish, impose and enforce limitations (after consultation) on the dollar amount of insured funds an insured institution may obtain through deposit brokers.

Arguments in Favor of the Bill

The FDIC and FHLBB would be able to curtail the abuse of brokered deposits by institutions that are classified as high risk or very high risk.

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Unlike the OCC and FRB proposals, the FDIC bill would give the insurance corporations maximum flexibility to adjust the restriction on brokered deposits. This is necessary because the market has proven to be very ingenious in its ability to get around regulatory and legal prohibitions.

#### Arguments Opposed to the Bill

The bill does not specify the caps that would be imposed on various classifications of institutions or how the FDIC and FHLBB would determine the classification of specific institutions. This gives the insurance agencies too much authority.

The FDIC prefers the current regulation on brokered deposits along with the provisions in the Improvements Act that authorize the FDIC Directors to classify types of accounts and determine their eligibility for insurance.

#### Agencies' Views

The OCC has prepared draft legislation on brokered deposits which it prefers to either the FDIC brokered deposits bill or the deposit categorization provision in the FDIIA. The OCC's bill would:

- limits the insurance coverage of a depositor on funds placed by any single broker to \$100,000 in a 5-year period;
- prohibits insured institutions with capital to asset ratios of less than three percent from accepting brokered deposits with maturities of less than 12 months; and
- if capital requirements are met, permits an institution to accept "short-term" brokered deposits as a percentage of total deposits up to two times the capital to asset ratio but never to accept brokered deposits equal to more than 15 percent of total assets.

The FDIC would prefer the more flexible approach that it has proposed in its bill, because regulations can be changed more easily than laws.

The Federal Reserve Board is expected to propose legislation that would prohibit an insured institution from accepting insured brokered deposits in excess of five percent of its daily average total deposits over the previous three months. A transitional period of six months would be provided for institutions that currently exceed this limit. Also, the

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FDIC and FHLBB would have recourse to a deposit broker to recover the amount of funds placed by such broker in institutions that exceed this percentage limitation, if the broker failed to obtain certification from the institution of its compliance with this limit.

The FHLBB will furnish information at a later date but almost certainly will oppose a bill allowing any brokered deposits.

Recommendation

The Working Group recommends supporting the FDIC bill if the bill is amended to include some form of the OCC provisions to determine which institutions can accept brokered deposits and to include specified limits on the amount of brokered deposits that institutions can accept. The bill, as drafted, gives the FDIC and FHLBB too much discretion.

Agree \_\_\_\_\_

Disagree \_\_\_\_\_

Other \_\_\_\_\_

APPENDIXSummary of the Federal Deposit Insurance Improvements Act of 1984

In November of 1983, Senator Garn, at the request of the FDIC introduced the Federal Deposit Insurance Improvements Act of 1983, S. 2103. Some of the substantive provisions in the bill that the Working Group found to be non-controversial include: (1) relaxing restrictions on Deposit Insurance National Banks (to allow them to act more like regular banks) thus increasing their usefulness for dealing with large failed banks; (2) eliminating most of the current procedural requirements applicable to bank branching and mergers; and (3) broadening the definition of affiliates to include subsidiaries of insured banks to allow the FDIC to examine them.

The non-controversial sections that would be added by the revised Improvements Act of 1984, which has not been introduced as yet, include: (1) providing that if someone has insured deposits in insured institutions that are merged, the combined funds will remain fully insured for a specified period of time, this now applies to just insured banks; and (2) providing that when the FDIC has transferred deposits to an insured bank as part of an arrangement for liquidating the affairs of a failed bank, and the deposits have been left unclaimed for 18 months, the FDIC can waive its rights to the deposits which previously were to be refunded to the FDIC. This makes record keeping easier for the acquiring bank and for the FDIC.

Sections of the Bill that the FDIC has Agreed to Alter

The CCEA Working Group met with representatives of the FDIC on April 25, 1984, to discuss the Federal Deposit Insurance Improvements Act of 1984. The FDIC agreed at that time to make changes in the bill.

Even with the agreed changes, general agreement has not been reached on some of these provisions and the Working Group must approve the FDIC's amended language before giving the Administration's final approval regarding these issues.

(1) Examination Fees. Section 8 of the bill would give the FDIC authority to charge fees for examining any bank. This is a very flexible and broad new authority. The FDIC, when discussing the bill, however, has made it clear that fees would only be charged for examinations that were required because a bank was a problem bank, thus requiring more examinations than a well run bank. If general economic conditions caused the problems (e.g. inflation), the fees would not be charged.

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The OCC strongly opposes this section of the bill. National and state banks are already assessed a fee to cover the cost of examinations by their primary supervisors. All insured banks are also assessed a fee by the FDIC for deposit insurance. Because it is only as a part of their insurance function that the FDIC would conduct examinations of national and state-member banks, it would be unfair to subject these banks to any additional FDIC examination charge.

Problem banks will already pay a premium under the risk-related rebated program of FDIIA. The OCC urges the Administration to oppose the imposition of a third layer of fees on national and state-member banks.

The CCEA Working Group felt that if the intention is to charge these fees for only abnormally long or frequent examinations, that this should be stipulated in the bill.

Therefore, the FDIC is now drafting language that will specify when the examination fees can be charged.

(2) Preemption of State Law - The bill provides, as a matter of preemptive law, that the FDIC is to serve as receiver for all insured banks and establish the priorities for distributing the assets of failed banks.

The Justice Department agreed that preemption of state law is necessary, if the FDIC is to be the receiver in all failed insured banks. In some states, (e.g. New Jersey), the FDIC would not be the receiver and therefore would not have the flexibility it needs to handle a failed bank situation.

Even though the Administration prefers not to support legislation preempting state law, the Working Group believes that in this case it is justified. The FDIC as the agency responsible for insuring bank deposits needs the authority to fulfill its responsibility in the case of a failed bank, therefore Federal law should stipulate the FDIC is to be appointed the receiver and has the authority to set the priorities for the payment of claims.